SHARE REORGANISATIONS, COMPANY TAKE-OVERS AND CAPITAL GAINS TAX

This Help Sheet deals with share reorganisations involving shares held by individuals, personal representatives and trustees. It explains the basic rules that apply to disposals in the tax year 2000-2001.

It should be read in conjunction with *Help Sheet IR284: Shares and Capital Gains Tax*, which explains the basic rules applying to the acquisition and disposal of shares. *Help Sheet IR284* explains the terms '1982 holding' and 'Section 104 holding'. Both Help Sheets assume the capital gain or loss will be calculated using the actual costs of acquisition and the actual disposal proceeds. Pages CGN13 and CGN14 of the Notes on Capital Gains explain the circumstances in which market value must be substituted for actual cost or disposal proceeds.

This Help Sheet explains only the basic rules, as they apply in simple cases. If you are in any doubt about your circumstances you should ask your tax adviser. Your Inland Revenue office will also be pleased to help. You can also consult the Inland Revenue Capital Gains Manual, which explains the rules in more detail. The Manual is available on the Inland Revenue website at www.inlandrevenue.gov.uk or you can ask to see it at your local Inland Revenue Enquiry Centre.

This Help Sheet explains:

- what a share reorganisation is
- what information is available about share reorganisations
- how the Capital Gains Tax rules deal with share reorganisations
- how you work out indexation allowance if the shares are held in a Section 104 holding
- how you work out indexation allowance if the shares are held in a 1982 holding
- how you deal with share reorganisations involving different classes of share
- the special rules for scrip dividends
- the special rules for demergers
- the special rules for take-overs if the company making the take-over issues shares and/or securities.

WHAT IS A SHARE REORGANISATION?

A share reorganisation is a general term used to describe transactions in which:

- new shares are issued to the shareholders in a company, **or**
- the rights attaching to shares are altered, **or**
- a company's share capital is reduced.

The most common transactions are bonus issues and rights issues. In both cases, new shares are allotted to some or all of the existing shareholders in proportion to their shareholdings. In a rights issue the allotment is provisional until the shareholder accepts he or she will pay for the shares. There are other transactions, such as open offers, which may be treated as share reorganisations where new shares are issued to existing shareholders in proportion to their shareholdings.

Other examples, not involving an issue of shares, include capital reorganisations and an alteration of the rights attaching to shares.

Example 1
Examples of share reorganisations which do not involve an issue of shares are:

- five 10p ordinary shares may be consolidated into one 50p ordinary share
- ordinary shares with no voting rights may be given the right to vote.

WHAT INFORMATION IS AVAILABLE ABOUT SHARE REORGANISATIONS?

This Help Sheet is concerned primarily with share reorganisations involving listed companies. If a listed company makes a share reorganisation it will almost always issue a circular or prospectus to its shareholders. This will include the company's explanation of the tax treatment. Often it will be followed up with more detailed advice. For example, the counterfoil attached to a new share certificate may give details of the allowable cost for a scrip dividend. You should keep this information. It will help you complete your Tax Return.

HOW ARE SHARE REORGANISATIONS DEALT WITH FOR CAPITAL GAINS TAX PURPOSES?

The basic Capital Gains Tax rules that apply to share reorganisations are:

- the issue of any new shares is not treated as an acquisition
- the loss or alteration of any old shares is not treated as a disposal.

Because a share reorganisation is not treated as an acquisition, any new shares of the same class that you receive are added to the holding in respect of which they were issued.

Example 2
You own 1,000 shares in IJK plc, 800 shares in a Section 104 holding and 200 shares which you bought on 2 August 1998. IJK plc makes a bonus issue of one new share for every two shares you hold. 400 new shares are added to the Section 104 holding, giving a total of 1,200 shares. 100 new shares are added to the acquisition on 2 August 1998 giving a total of 300 shares.

Because you are not treated as acquiring the new shares, the same day rule and the bed and breakfasting rule, (see the section 'How to identify the shares disposed of' in *Help Sheet IR284: Shares and Capital Gains Tax*), do not apply.

Example 3
On 6 May 1998 you buy 1,100 shares in LMN plc. On 4 February 2001 you sell 200 shares. On 3 March 2001 LMN plc makes a bonus issue of one share for every three shares held. You receive 300 new shares.

The bonus issue is a share reorganisation. Your 300 new shares are therefore not treated as acquired on 3 March 2001. The 200 shares sold on 4 February 2001 are not matched with 200 of the new shares under the 30 day bed and breakfasting rule.

Instead the 200 shares sold are identified with 200 of your original 1,100 shares. The 300 new shares are added to the 900 shares remaining after the sale of the 200 shares, bringing the total up to 1,200.

There are special rules that deal with the allowance of any amounts you have to pay on a share reorganisation. These are explained on pages 3 and 4. There are also special rules which apply to the taxation of any amounts you receive other than the issue of new shares. These are explained in the section on take-overs on page 6.

If the shares you acquire on the reorganisation are not of the same class, they will form a separate holding. The cost of the original shares is apportioned, (see the section on 'Share reorganisations involving different classes of shares' on page 5).

HOW TO WORK OUT INDEXATION ALLOWANCE IF THE SHARES ARE HELD IN A SECTION 104 HOLDING

If the share reorganisation is a bonus issue there is no allowable expenditure to add to the pools of actual cost and indexed cost. It is therefore not an 'operative event'. (For an explanation of this term see the section 'How to work out the gain for shares in a Section 104 holding' in *Help Sheet IR284: Shares and Capital Gains Tax*.) You merely add the new shares to the total number of shares in the pool. There is no other adjustment to be made for indexation purposes.

If the share reorganisation is a rights issue, it is an 'operative event'. You add indexation to the pool of indexed cost. You then add the cost of the new shares to the pool of actual cost and the pool of indexed cost. The amount of indexation which you add depends on the date you pay for the new shares:

- if the date was before 6 April 1998, you add indexation up to the date of payment
- if the date was on or after 6 April 1998, you add indexation up to April 1998, unless the pool of indexed cost has already been indexed up to that date, in which case no additional indexation is due.

The cost of the new shares is added to the pool of actual cost and the pool of indexed cost.

Example 4

In April 1996 you buy 1,000 shares in OPQ plc for £7,000. On 26 May 1997 OPQ plc declares a 1 for 5 rights issue at a price of £9 per share. You take up your full entitlement to 200 shares. On 2 June 2000 you sell 300 shares for £12 per share. Following the steps in the paragraph headed 'How to work out the gain for shares in a Section 104 holding' in *Help Sheet IR284*, you work out the gain as follows.

			Number of shares	Pool of actual cost	Pool of indexed cost
Step 1	**April 1996**	The pool is formed	1,000	£7,000	£7,000
Step 2	**May 1997**	Give indexation allowance from April 1996 to May 1997. Multiply the pool of indexed cost at Step 1 by the indexation factor and add this to the pool of indexed cost, £7,000 x 0.028 = £196. Add the cost of the new shares 200 x £9 = £1,800 to the pool's actual cost and indexed cost.			
		add indexation			£196
		add cost of new shares	200	£1,800	£1,800
			1,200	£8,800	£8,996
Step 3	**June 2000**	Give indexation from May 1997 to April 1998. Multiply the pool of indexed cost by the indexation factor and add this to the pool of indexed cost £8,996 x 0.036			£324
			1,200	£8,800	£9,320

Calculate the gain or loss. **First**, calculate the allowable cost and indexation allowance available. Multiply the two pools of cost by:

$$\frac{\text{Number of shares sold}}{\text{Total number of shares in the pool}} = \frac{300}{1,200}$$

Indexed cost £9,320 x $\frac{300}{1,200}$ = £2,330

Actual cost £8,800 x $\frac{300}{1,200}$ = £2,200

Indexation allowance = £130

Second, calculate the gain or loss:

Disposal proceeds	£3,600
minus allowable cost	£2,200
Unindexed gain	£1,400
minus Indexation allowance	£130
Chargeable gain (before taper relief)	£1,270

Third, adjust the two pools in the Section 104 holding:

	Number of shares	Pool of actual cost	Pool of indexed cost
Brought forward	1,200	£8,800	£9,320
	minus 300	*minus* £2,200	*minus* £2,330
Carried forward	900	£6,600	£6,990

HOW TO WORK OUT INDEXATION ALLOWANCE IF THE SHARES ARE HELD IN A 1982 HOLDING

There is no allowable expenditure if a bonus issue is made in respect of shares in a 1982 holding. The effect of the bonus issue is to reduce the average cost of the shares in the holding.

Example 5

Suppose you have made the election described in the section 'What is Rebasing?' on page CGN13 of the Notes on Capital Gains Pages, so that all your assets are held at their 31 March 1982 value. You have a 1982 holding of 1,000 shares in RST plc with a cost equal to their 31 March 1982 value of £2 per share. In 1997 RST plc makes a one for one bonus issue. You now have 2,000 shares held at a capital gains cost of £1 per share. If you sell 500 shares, indexation allowance will be given on £500.

You are entitled to an allowable deduction for the amounts you pay for the shares issued on a rights issue. Any indexation allowance due on these amounts is only given from the date you pay or become liable to pay for the new shares.

Example 6

You have a 1982 holding of 1,000 shares in UVW plc. In May 1994 the company declares a one for two rights issue at £4 per share. You accept your full entitlement of 500 shares at a total cost of £2,000. In June 2000 you sell 400 shares at a price of £8.50 per share. The 31 March 1982 value of the shares is £2.50 per share. You have made an election for the 31 March 1982 value to apply to the assets you held on that date.

The 1982 holding consists of the following shares:

	Shares	**Cost/31 March 1982 value**
Shares held at 31 March 1982	1,000	£2,500
Rights issue	500	£2,000
	1,500	£4,500

You work out the allowable expenditure as follows:

$$\frac{\text{Shares sold}}{\text{Total shares held}} \quad \frac{400}{1{,}500} \times £4{,}500 = £1{,}200$$

Indexation allowance on the shares held at 31 March 1982 is due from that date. Indexation allowance on the shares issued on the rights issue is due only from the date you paid for them (May 1994):

$$£2{,}500 \times \frac{400}{1{,}500} \times 1.047 = £698$$

$$£2{,}000 \times \frac{400}{1{,}500} \times 0.124 = £66$$

£764

You work out the chargeable gain as follows:

Disposal proceeds	£3,400
minus allowable cost	£1,200
Unindexed gain	£2,200
minus Indexation allowance	£764
Chargeable gain (before taper relief)	£1,436

Notes on computation

1. You may not have made an election for the 31 March 1982 value to apply to all your assets. If so you will also have to work out the gain using the cost of the shares held at 31 March 1982. As explained in the paragraph headed 'What is Rebasing?' on page CGN13 in the Notes on Capital Gains Pages, you compare this gain with the gain used in the 31 March 1982 value.

2. For disposals on or after 6 April 1998 indexation allowance is due only up to April 1998. So if you had acquired the rights issue shares on or after 6 April 1998 no indexation would be due on the cost of acquiring them.

SHARE REORGANISATIONS INVOLVING DIFFERENT CLASSES OF SHARES

The shares issued on a share reorganisation may be of a different class from the shares you already own. Because the shares are of different classes you cannot identify the allowable cost of the shares using the number of shares disposed of. Instead, you identify the allowable cost and the respective values of the shares using the formula:

$$\text{Cost} \times \frac{\text{Value of shares disposed of}}{\text{Value of shares disposed of + value of shares still held}}$$

The time at which you split the cost of the different classes of share depends on whether or not any of the shares are **quoted** on the Daily Official List of the Stock Exchange, or any other recognised Stock Exchange, within 3 months of the reorganisation taking effect:

- **quoted shares** - you value the different classes of share on the first day when values are quoted for the shares in the reorganisation
- **unquoted shares** - you wait until you dispose of some of the shares before splitting the cost. The values you use in the formula are the values of the shares at the time of the disposal.

Example 7

In May 1986 you buy 1,000 £1 ordinary shares in FGH plc, a quoted company, for £1,800. In March 1995 FGH plc makes a rights issue of one £1 'A' ordinary share for every four £1 ordinary shares held at a price of £2.50 per share. You take up your full entitlement of 250 £1 'A' ordinary shares at a cost of £625. On the day after the share reorganisation, the £1 ordinary shares had a value of £8 per share, and the £1 'A' ordinary shares a value of £2.60 per share.

You split the cost of the different classes of share as follows.

Step 1 Calculate the cost and indexation allowance due up to and including the share reorganisation.

	Number of shares		Pool of actual cost	Pool of indexed cost
	ord.	'A' ord		
May 1986	1,000		£1,800	£1,800
Indexation allowance May 1986 - March 1995 0.507				+ £913
March 1995 - Rights issue		250	£625	+ £625
Holding at March 1995	1,000	250	£2,425	£3,338

Step 2 Split the cost of the two pools of expenditure. The amount allocated to the £1 ordinary shares is given by the formula

$$\frac{\text{Value £1 ords}}{\text{Value £1 ords + Value £1 'A' ords}} \quad \frac{1{,}000 \times £8}{(1{,}000 \times £8) + (250 \times £2.60)} = \frac{8{,}000}{8{,}650}$$

Pool of actual cost $£2{,}425 \times \frac{8{,}000}{8{,}650} = £2{,}243$

Pool of indexed cost $£3{,}338 \times \frac{8{,}000}{8{,}650} = £3{,}087$

At March 1995 you have a Section 104 holding of £1 ords:

Number of shares	Pool of actual cost	Pool of indexed cost
1,000	£2,243	£3,087

and a Section 104 holding of 'A' ords:

Number of shares	Pool of actual cost	Pool of indexed cost
250	£182	£251

SCRIP OR STOCK DIVIDENDS

In a scrip or stock dividend, the company paying a dividend gives its shareholders the option of taking the dividend in the form of new shares rather than cash. It is a form of bonus issue as the shareholders do not pay for the new shares. Shareholders who take shares are taxable on the dividend. They are treated as having received an amount called 'the appropriate amount in cash', which attracts Income Tax.

For Capital Gains Tax purposes, shareholders are treated as though they paid the appropriate amount in cash for the new shares. In other words, the appropriate amount in cash is the allowable expenditure on the new shares. If the scrip dividend shares are issued **before 6 April 1998** you work out the capital gains on any later disposal of shares in a Section 104 holding or 1982 holding by treating the stock dividend in the same way as a rights issue. Indexation allowance is given from the month the dividend became payable.

If the scrip dividend shares are issued **on or after 6 April 1998** they are treated as a separate new acquisition. For further information on how to work out when these shares are disposed of and the gain or loss arising, see pages 2 and 3 of *Help Sheet IR284: Shares and Capital Gains Tax*.

If a scrip dividend is paid by a listed company, that company will usually explain the tax treatment and tell you the value of the appropriate amount in cash.

This explanation may not apply to scrip dividends received by trustees, so please ask your Inland Revenue office, or tax adviser, for details.

DEMERGERS

A demerger in which a company distributes shares in a subsidiary to its shareholders may be treated as a share reorganisation. Because the shareholder will then own shares in the original company and the subsidiary, this is a share reorganisation involving different classes of share. It is therefore necessary to apportion the allowable cost of the shares using the rules explained in the section 'Share reorganisations involving different classes of share' on page 5. A listed company making a demerger will usually tell its shareholders whether the demerger is a share reorganisation.

TAKE-OVERS

When a company takes over another it may issue its own shares and/or securities in payment or part payment for the shares it is buying. Under certain conditions this is treated as a share reorganisation. If the take-over is by a listed company, the information you receive about the take-over will usually say whether these conditions are met. The payment can consist of a mixture of cash, shares and securities. The treatment of these different elements is described below.

All shares

If the company making the take-over only issues shares, you are treated as though you acquire the new shares at the same time and at the same price as the old shares. You may already own shares in the company making the take-over. If the new shares and the existing holding are both Section 104 holdings, or are both 1982 holdings, the newly issued shares and your existing holding will be merged.

Example 8

You have the following holdings of shares:

	1982 holding shares	Cost	Section 104 holding shares	Cost
KNO Ltd	1,000	£1,200	5,000	£6,000
RST Ltd	1,000	£1,800	2,000	£8,000

RST Ltd takes over KNO Ltd and issues 5 RST Ltd shares for every one KNO Ltd share held. 5,000 shares are issued in respect of the 1982 holding and 25,000 shares in respect of the Section 104 holding. You are treated as having acquired these shares at the same cost or 31 March 1982 value as the KNO Ltd shares. The holding of RST Ltd shares now becomes:

	1982 holding shares	Cost	Section 104 holding shares	Cost
RST Ltd	6,000	£3,000	27,000	£14,000

Shares and cash

If the company making the take-over gives you cash and shares, you may have to pay Capital Gains Tax on the cash you receive. If the amount of cash you receive is 'small', compared with the value of your shares in the original company immediately before the take-over, there may be no immediate liability. If the allowable cost of your original shares is more than the cash received, you simply reduce the cost by the amount of the cash receipt and use the reduced amount of cost to work out your gain or loss on a later disposal of the new shares you received in the take-over. If the cash received is more than the allowable cost, you reduce the cost to nil for later disposals of the new shares and have an immediate gain equal to the excess of the cash over the cost.

The Inland Revenue accepts that a cash receipt on a take-over is 'small' if **either** it is less than £3,000 in total, **or** it is not more than 5% of the value of the shares in the original company immediately before the take-over. If the cash you receive is not 'small', you will need to work out your gain or loss on the cash received by apportioning the allowable cost of the shares in the original company between the cash received and the shares received. You do this by reference to the value of what you receive. The formula is:

$$\frac{\text{Value of cash received}}{\text{Value of cash received + value of shares received.}}$$

Example 9
You have a Section 104 holding of 20,000 shares in CDE Ltd. On 17 March 2001 CDE Ltd is taken over by WXY Ltd. WXY Ltd pays £4 in cash and issues 2 shares for each share in CDE Ltd. On 17 March 2001 each WXY Ltd share is worth £6.

The Section 104 holding of WXY Ltd shares including indexation allowance up to April 1998 is:

Number of shares	Pool of actual cost	Pool of indexed cost
20,000	£60,000	£94,440

The receipt of the cash on the take-over is treated as a capital distribution.

Using consideration received the part disposal formula becomes:

$$\frac{20{,}000 \times £4}{(20{,}000 \times £4) + (40{,}000 \times £6)} = \frac{1}{4}$$

Pool of indexed cost	£94,440 x $^1/_4$	=	£23,610
Pool of actual cost	£60,000 x $^1/_4$	=	£15,000
	Indexation allowance		£8,610

Capital Gains Tax calculation:

	Disposal proceeds	£80,000
minus	Cost	£15,000
	Unindexed gain	£65,000
minus	Indexation allowance	£8,610
	Chargeable gain (before taper relief)	£56,390

You now have a Section 104 holding of 40,000 WXY Ltd shares.

Number of shares	Pool of actual cost	Pool of indexed cost
40,000	£45,000	£70,830
	(£60,000 *minus* £15,000)	(£94,440 *minus* £23,610)

Securities

The company making the take-over may issue securities such as loan notes. This is sometimes described as a 'loan note alternative' to the cash offer. The tax treatment depends on whether the securities are Qualifying Corporate Bonds. The information given to you at the time of the take-over should say whether the securities are Qualifying Corporate Bonds.

If the securities are Qualifying Corporate Bonds the rules are as follows. You calculate the gain that would have arisen if the shares in the company being taken over were sold at their market value immediately before the take-over. That gain becomes chargeable as and when the securities are disposed of. There is no separate gain on the disposal of the Qualifying Corporate Bonds themselves.

Example 10
You own 1,000 shares in JLM Ltd. JLM Ltd is taken over by NPR Ltd which issues securities worth £5 for every share in JLM Ltd you hold. The securities are Qualifying Corporate Bonds. Your holding of JLM Ltd shares was worth £5,000 immediately before the take-over. If the cost plus indexation due on these shares is £3,500 this would give a notional gain of £1,500 immediately before the take-over. If you dispose of half the securities that will release a gain of £750.

If you receive cash as well as Qualifying Corporate Bonds on a take-over you may have to pay Capital Gains Tax on the cash you receive, unless the amount of cash is 'small'. See the section on page 6 headed 'Shares and cash' for the meaning of 'small'. If the cash amount is 'small' it is ignored and you follow the rules described in the paragraph above to calculate the gain that becomes chargeable when the securities are disposed of. If the cash is not 'small' you still calculate the gain as described above, but a proportionate part of the gain is chargeable at the time of the take-over. For example, if you received £25,000 in cash and Qualifying Corporate Bonds worth £75,000, one-quarter of the gain would be chargeable at the time of the take-over and three-quarters of the gain would be chargeable when you disposed of the Qualifying Corporate Bonds.

If the securities are not Qualifying Corporate Bonds you follow the rules described in the paragraph on page 6 headed 'All shares'.

Cash/shares/securities

The company making the take-over may offer a combination of cash, shares and securities. You will have to apportion the allowable cost of the shares in the company being taken over between the different elements of the consideration received. As shown in the examples above, you do this by reference to the values of what is given or received.

Earn-outs

Some company take-overs may include an earn-out right, where the amount of the consideration to be paid depends on, for example, the future profits of the company. Because the amount cannot be calculated at the time of the take-over, the value of the earn-out right itself represents disposal proceeds. However, if you receive an earn-out right which can be satisfied **only** by an issue of shares or securities, you may elect for the right to be treated as if it was itself a security. If you make this election, which is irrevocable, the earn-out right is treated as a security which is not a Qualifying Corporate Bond. The election allows the rules of take-overs described in the paragraph on page 6 headed 'All shares' to apply on receipt of the earn-out right. The rules above will also apply when you actually receive any shares or securities under the terms of the earn-out.

The rules in relation to earn-outs can be a complex matter. If you receive an earn-out right you are advised to consult your professional adviser, or ask to see the Inland Revenue Capital Gains Manual at your local Inland Revenue Enquiry Centre.

The time limit for an election to treat an earn-out right as a security is 12 months from 31 January in the tax year following that in which the right was conferred. So if the right was conferred in 2000-2001 the time limit is 31 January 2003.

If you want to make an election in respect of a right conferred in 2000-2001, you should normally include this in column G on Page CG2 of the Capital Gains Pages.

But if, because of the election, you are treated as not making any disposal of your old shares and receiving **only** shares and securities, you should make the election on the 'Additional information' page CG7. You should

- describe the transaction which resulted in the earn-out right being granted, **and**
- confirm that an election to treat the earn out right as a security under section 138A(2) TCGA 1992 is made.

These notes are for guidance only, and reflect the position at the time of writing. They do not affect any rights of appeal.